

Form 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934 For the Quarterly Period Ended June 30, 2002

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934

For the transition period from \_\_\_\_ to \_\_\_\_

Commission file number 1-13105

ARCH COAL, INC.

(Exact name of registrant as specified in its charter)

Delaware 43-0921172  
(State or other jurisdiction of (I.R.S. Employer Identification No.)  
incorporation or organization)

One CityPlace Drive, Suite 300, St. Louis, Missouri 63141  
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (314) 994-2700

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes X No \_\_\_\_

At August 1, 2002, there were 52,379,802 shares of registrant's common stock outstanding.

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## PART I - FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

ARCH COAL, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED BALANCE SHEETS  
(IN THOUSANDS)

	June 30, 2002	December 31, 2001
	-----	-----
	(Unaudited)	
<b>Assets</b>		
Current assets		
Cash and cash equivalents	\$ 1,343	\$ 6,890
Trade accounts receivable	145,970	149,956
Other receivables	32,318	32,303
Inventories	76,084	60,133
Prepaid royalties	2,460	1,997
Deferred income taxes	23,840	23,840
Other	11,118	14,337
	-----	-----
Total current assets	293,133	289,456
	-----	-----
Property, plant and equipment, net	1,406,681	1,396,786
	-----	-----
Other assets		
Prepaid royalties	51,116	35,216
Coal supply agreements	70,936	81,424
Deferred income taxes	202,178	195,411
Investment in Canyon Fuel	153,978	170,686
Other	45,021	34,580
	-----	-----
Total other assets	523,229	517,317
	-----	-----
Total assets	\$2,223,043	\$ 2,203,559
	=====	=====
<b>Liabilities and stockholders' equity</b>		
Current liabilities		
Accounts payable	\$ 124,036	\$ 99,081
Accrued expenses	141,004	134,062
Current portion of debt	6,497	6,500
	-----	-----
Total current liabilities	271,537	239,643
Long-term debt	790,641	767,355
Accrued postretirement benefits other than pension	323,571	326,098
Accrued reclamation and mine closure	127,557	123,761
Accrued workers' compensation	82,631	78,768
Accrued pension cost	839	22,539
Obligations under capital leases	519	8,210
Other noncurrent liabilities	61,517	66,443
	-----	-----
Total liabilities	1,658,812	1,632,817
	-----	-----
Stockholders' equity		
Common stock	527	527
Paid-in-capital	835,716	835,427
Retained deficit	(250,631)	(239,336)
Treasury stock, at cost	(5,047)	(5,047)
Accumulated other comprehensive loss	(16,334)	(20,829)
	-----	-----
Total stockholders' equity	564,231	570,742
	-----	-----
Total liabilities and stockholders' equity	\$2,223,043	\$ 2,203,559
	=====	=====

See notes to condensed consolidated financial statements.

ARCH COAL, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
(IN THOUSANDS, EXCEPT PER SHARE DATA)  
(UNAUDITED)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
<b>Revenues</b>				
Coal sales	\$358,990	\$ 350,214	\$717,585	\$710,257
Income (loss) from equity investment	(198)	4,247	1,070	10,306
Other revenues	15,684	14,119	24,287	29,444
	-----	-----	-----	-----
	374,476	368,580	742,942	750,007
	-----	-----	-----	-----
<b>Costs and expenses</b>				
Cost of coal sales	340,928	332,577	688,139	662,102
Selling, general and administrative expenses	10,071	12,043	19,940	25,837
Amortization of coal supply agreements	5,374	7,575	10,488	15,161
Other expenses	5,781	4,196	13,373	8,525
	-----	-----	-----	-----
	362,154	356,391	731,940	711,625
	-----	-----	-----	-----
Income from operations	12,322	12,189	11,002	38,382
<b>Interest expense, net:</b>				
Interest expense	(14,356)	(14,726)	(26,358)	(36,080)
Interest income	314	3,386	582	3,637
	-----	-----	-----	-----
	(14,042)	(11,340)	(25,776)	(32,443)
	-----	-----	-----	-----
Income (loss) before income taxes	(1,720)	849	(14,774)	5,939
Income tax benefit	(3,800)	-	(9,500)	(1,000)
	-----	-----	-----	-----
Net income (loss)	\$ 2,080	\$ 849	\$ (5,274)	\$ 6,939
	=====	=====	=====	=====
<b>Earnings (loss) per common share</b>				
Basic	\$ 0.04	\$ 0.02	\$ (0.10)	\$ 0.16
Diluted	\$ 0.04	\$ 0.02	\$ (0.10)	\$ 0.15
	=====	=====	=====	=====
Dividends declared per share	\$ 0.0575	\$0.0575	\$ 0.1150	\$ 0.1150
	=====	=====	=====	=====

See notes to condensed consolidated financial statements.

ARCH COAL, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
(IN THOUSANDS)  
(UNAUDITED)

	Six Months Ended June 30,	
	2002	2001
Operating Activities		
Net income (loss)	\$ (5,274)	\$ 6,939
Adjustments to reconcile to cash provided by operating activities:		
Depreciation, depletion and amortization	86,589	89,109
Prepaid royalties expensed	3,674	3,304
Net gain on disposition of assets	(607)	(3,862)
Income from equity investment	(1,070)	(10,306)
Net distributions from equity investment	17,778	27,245
Changes in:		
Receivables	3,971	962
Inventories	(15,951)	(3,701)
Accounts payable and accrued expenses	13,898	(4,081)
Income taxes	(9,640)	(7,639)
Accrued postretirement benefits other than pension	(2,527)	(9,174)
Accrued reclamation and mine closure	3,796	(2,325)
Accrued workers' compensation benefits	3,863	1,619
Other	(1,029)	(3,146)
Cash provided by operating activities	97,471	84,944
Investing activities		
Additions to property, plant and equipment	(96,089)	(64,635)
Proceeds from dispositions of property, plant and equipment	2,162	4,595
Additions to prepaid royalties	(20,037)	(20,114)
Cash used in investing activities	(113,964)	(80,154)
Financing activities		
Net proceeds from (payments on) revolver and lines of credit	23,283	(247,841)
Payments on term loans	-	(135,000)
Debt financing costs	(8,127)	-
Proceeds from sale and leaseback of equipment	9,213	-
Reduction of obligations under capital leases	(7,691)	(1,274)
Dividends paid	(6,021)	(5,524)
Proceeds from sale of common stock	289	380,985
Cash provided by (used in) financing activities	10,946	(8,654)
Decrease in cash and cash equivalents	(5,547)	(3,864)
Cash and cash equivalents, beginning of period	6,890	6,028
Cash and cash equivalents, end of period	\$ 1,343	\$ 2,164

See notes to condensed consolidated financial statements.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 JUNE 30, 2002  
 (UNAUDITED)

Note A - General

The accompanying unaudited Condensed Consolidated Financial Statements have been prepared in accordance with generally accepted accounting principles for interim financial reporting and Securities and Exchange Commission regulations, but are subject to any year-end adjustments that may be necessary. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Results of operations for the period ended June 30, 2002 is not necessarily indicative of results to be expected for the year ending December 31, 2002. Arch Coal, Inc. (the "Company") operates one reportable segment: the production of steam and metallurgical coal from surface and deep mines throughout the United States, for sale to utility, industrial and export markets. The Company's mines are primarily located in the central Appalachian and western regions of the United States. All subsidiaries (except as noted below) are wholly owned. Significant intercompany transactions and accounts have been eliminated in consolidation.

The Company's Wyoming, Colorado and Utah coal operations are included in a joint venture named Arch Western Resources, LLC ("Arch Western"). Arch Western is 99% owned by the Company and 1% owned by BP Amoco. The Company also acts as the managing member of Arch Western.

The membership interests in the Utah coal operations, Canyon Fuel Company, LLC ("Canyon Fuel"), are owned 65% by Arch Western and 35% by a subsidiary of ITOCHU Corporation. The Company's 65% ownership of Canyon Fuel is accounted for on the equity method in the Condensed Consolidated Financial Statements as a result of certain super-majority voting rights in the joint venture agreement. Income from Canyon Fuel is reflected in the Condensed Consolidated Statements of Operations as income from equity investment (see additional discussion in "Investment in Canyon Fuel" in Note C).

Note B - Other Comprehensive Income

Other comprehensive income items under FAS 130, Reporting Comprehensive Income, are transactions recorded in stockholders' equity during the year, excluding net income and transactions with stockholders. The following table presents comprehensive income:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
	(in thousands)			
Net income (loss)	\$ 2,080	\$ 849	\$ (5,274)	\$ 6,939
Other comprehensive income (loss) net of income tax benefit	(1,608)	1,282	4,495	(7,902)
Total comprehensive income (loss)	\$ 472	\$2,131	\$ (779)	\$ (963)

Note C - Investment in Canyon Fuel

The following table presents unaudited summarized financial information for Canyon Fuel, which is accounted for on the equity method:

Condensed Income Statement Information	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
	(in thousands)			
Revenues	\$ 59,652	\$ 71,357	\$ 137,300	\$ 141,521
Total costs and expenses	62,445	64,678	139,599	126,832
Net income (loss)	\$ (2,793)	\$ 6,679	\$ (2,299)	\$ 14,689
65% of Canyon Fuel net income (loss)	\$ (1,815)	\$ 4,341	\$ (1,494)	\$ 9,548
Effect of purchase adjustments	1,617	(94)	2,564	758
Company's income (loss) from its equity investment in Canyon Fuel	\$ (198)	\$ 4,247	\$ 1,070	\$ 10,306

The Company's income (loss) from its equity investment in Canyon Fuel represents 65% of Canyon Fuel's net income (loss) after adjusting for the effect of purchase adjustments primarily related to its investment in Canyon Fuel. The Company's investment in Canyon Fuel reflects purchase adjustments primarily related to the reduction in amounts assigned to sales contracts, mineral reserves and other property, plant and equipment. The purchase adjustments are amortized consistent with the underlying assets of the joint venture.

#### Note D - Inventories

Inventories consist of the following:

	June 30, 2002	December 31, 2001
	(in thousands)	
Coal	\$ 45,373	\$ 28,165
Repair parts and supplies	30,711	31,968
	\$ 76,084	\$ 60,133

#### Note E - Debt

Debt consists of the following:

	June 30, 2002	December 31, 2001
	(in thousands)	
Indebtedness to banks under lines of credit	\$ 5,600	\$ 13,500
Indebtedness to banks under revolving credit agreement, expiring April 18, 2007	115,000	80,000
Indebtedness to banks under variable rate, non-amortizing term loan due April 18, 2007	150,000	-
Indebtedness to banks under variable rate, non-amortizing term loan due April 18, 2008	525,000	-
Indebtedness to banks under variable rate, non-amortizing term loan due May 31, 2003	-	675,000
Other	1,538	5,355
	797,138	773,855
Less current portion	6,497	6,500
Long-term debt	\$ 790,641	\$ 767,355

On April 18, 2002, the Company and Arch Western completed a refinancing of their existing credit facilities. The new credit facilities include five- and six-year non-amortizing term loans totaling \$675.0 million at Arch Western and a five-year revolving credit facility totaling \$350.0 million for the Company. The five-year non-amortizing term loan at Arch Western is for \$150.0 million and the six-year non-amortizing term loan is for \$525.0 million. The rate of interest on borrowings under both of the credit facilities is a floating rate based on LIBOR. The Company's credit facility is secured by ownership interests in substantially all of its subsidiaries, except its ownership interests in Arch Western and its subsidiaries. The Arch Western credit facility is secured by its ownership interests in substantially all of its subsidiaries, but is not guaranteed by the Company.

#### Note F - Contingencies

The Company is a party to numerous claims and lawsuits with respect to various matters. The Company provides for costs related to contingencies when a loss is probable and the amount is reasonably determinable. After conferring with counsel, it is the opinion of management that the ultimate resolution of these claims, to the extent not previously provided for, will not have a material adverse effect on the consolidated financial position, results of operations or liquidity of the Company.

#### Note G - Changes in Estimates and Other Non-Recurring Revenues and Expenses

During the three and six months ended June 30, 2002, the Company settled certain coal contracts with a customer that was partially unwinding its coal supply position and desired to buy out of the remaining terms of those contracts. The settlements resulted in a pre-tax gain of \$5.6 million which was recognized in other revenues in the Condensed Consolidated Statements of Operations.

The Company recognized a pre-tax gain of \$4.6 million during the quarter as a result of a workers' compensation premium adjustment refund from the State of West Virginia. During 1998, the Company entered into the West Virginia workers' compensation plan at one of its subsidiary operations. The subsidiary paid standard base rates until the West Virginia Division of Workers' Compensation could determine the actual rates based on claims experience. Upon review, the Division of Workers' Compensation refunded \$4.6 million in premiums which the Company received during the quarter ended June 30, 2002. Partially offsetting this gain was an increase to the workers' compensation accrual resulting in a pre-tax loss of \$3.3 million caused by adverse experience at several of the Company's self insured locations. These workers' compensation items were recognized as adjustments to costs of coal sales in the Condensed Consolidated Statements of Operations.

The Company's operating results for the three and six months ended June 30, 2001 reflect a \$9.4 million insurance settlement as part of the Company's coverage under its property and business interruption policy. The insurance settlement represents the final settlement for losses incurred at the West Elk Mine in Gunnison County Colorado, which was idled from January 28, 2000 to July 12, 2000 following the detection of combustion-related gasses. The final settlement was recorded as a reduction in cost of coal sales in the Condensed Consolidated Statement of Operations.

During the six months ended June 30, 2001, the Company reduced its reclamation liability resulting in a pre-tax gain of \$3.5 million recognized as a reduction in cost of coal sales. Permit revisions at its idle mine properties in Illinois allowed for the reduction in the reclamation liability. In addition, during the second quarter of 2001, as a result of progress in processing claims associated with the recovery of certain previously paid excise taxes on export sales, the Company recognized a pre-tax gain of \$4.6 million. Of the \$4.6 million recognized, \$3.1 million represents the interest component of the claim and was recorded as interest income. The gain stems from an IRS notice during the second quarter of 2000 outlining the procedures for obtaining tax refunds on black lung excise taxes paid by the industry on export sales. The notice was the result of a 1998 federal district court decision that found such taxes to be unconstitutional.

The Company recorded pre-tax charges of \$2.0 million and \$8.3 million for the three and six months ended June 30, 2001, respectively, for stock-based compensation benefit programs that may be realized in future periods as a result of improved stock performance. The Company also reduced interest expense by \$1.7 million during the three and six month periods ended June 30, 2001 primarily

associated with the termination of certain interest rate swaps, which did not qualify as hedges under accounting prescribed by FAS 133, "Accounting for Derivative Instruments and Hedging Activities." During the second quarter of 2001, Canyon Fuel, the Company's equity method investment, recovered previously paid property taxes. The Company's share of these recoveries was \$2.6 million and is reflected in income from equity investment on the Condensed Consolidated Statements of Operations.

Note H - Earnings (Loss) per Share

The following table sets forth the computation of basic and diluted earnings (loss) per common share from continuing operations.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
(in thousands, except per share data)				
Numerator:				
Net income (loss)	\$ 2,080	\$ 849	\$ (5,274)	\$ 6,939
Denominator:				
Weighted average shares - denominator for basic	52,377	48,984	52,367	44,721
Dilutive effect of employee stock options	295	601	-	386
Adjusted weighted average shares - denominator for diluted	52,672	49,585	52,367	45,107
Earnings (loss) per common share				
Basic	\$ .04	\$ .02	\$ (.10)	\$ .16
Diluted	\$ .04	\$ .02	\$ (.10)	\$ .15

Note I - Other Items

On April 19, 2002, the Company created a limited partnership, Natural Resource Partners L.P., with three private affiliated companies: Western Pocahontas Properties Limited Partnership, Great Northern Properties Limited Partnership and New Gauley Coal Corporation. Natural Resource Partners was formed to engage principally in the business of owning and managing coal royalty properties in the three major coal producing regions in the United States: Appalachia, the Illinois Basin and the Western United States. A registration statement on Form S-1 has been filed with the Securities and Exchange Commission relating to a proposed underwritten initial public offering of common units representing limited partner interests in Natural Resource Partners. The Company will contribute approximately 454 million tons of its 3.4 billion tons of total coal reserves to Natural Resource Partners in exchange for its ownership interest in the partnership.

Note J - Accounting Development

In June 2001, the Financial Accounting Standards Board issued FAS 143, "Accounting for Asset Retirement Obligations," which is effective for fiscal years beginning after June 15, 2002. The statement requires legal obligations associated with the retirement of long-lived assets to be recognized at their fair value at the time that the obligations are incurred. Upon initial recognition of a liability, that cost should be capitalized as part of the related long-lived asset and allocated to expense over the useful life of the asset. The Company will adopt FAS 143 on January 1, 2003. Due to the significant number of mines that the Company operates throughout the United States and the extensive amount of information that must be reviewed and estimates that must be made to assess the effects of the statement, the expected impact of adoption of FAS 143 on the Company's financial position or results of operations has not yet been determined.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

FORWARD-LOOKING STATEMENTS

Statements in this quarterly report which are not statements of historical fact are forward-looking statements within the "safe harbor" provision of the Private Securities Litigation Reform Act of 1995. These forward-looking statements are based on the information available to, and the expectations and assumptions deemed reasonable by, the Company at the time the statements were made. Because these forward-looking statements are subject to various risks and uncertainties, actual results may differ materially from those projected in the statements. These expectations, assumptions and uncertainties include the Company's expectation of growth in the demand for electricity; belief that legislation and regulations relating to the Clean Air Act and the relatively higher costs of competing fuels will increase demand for its compliance and low-sulfur coal; expectation that the Company will continue to have adequate liquidity from its cash flow from operations, together with available borrowings under its credit facilities, to finance the Company's working capital needs and meet its debt reduction goals; a variety of market, operational, geologic, permitting, labor and weather related factors and the other risks and uncertainties which are described below under "Contingencies" and "Certain Trends and Uncertainties."

RESULTS OF OPERATIONS

Quarter Ended June 30, 2002, Compared  
to Quarter Ended June 30, 2001

Net Income. Net income for the quarter ended June 30, 2002 was \$2.1 million compared to net income of \$0.8 million for the quarter ended June 30, 2001. Results for the current quarter were negatively impacted by the state of oversupply in the coal market that resulted from an extremely mild winter and a period of economic weakness that dampened electricity demand. As a result, during the first quarter and continuing into the second quarter of 2002, the Company reduced the rate of production from planned levels at its mining operations. In addition, as described below, the Company continued to be negatively impacted by production difficulties at its Samples surface operation in West Virginia. Partially offsetting these negative items in the current quarter were higher contract prices for coal shipped during the quarter compared to the same period in the prior year and reduced interest expense associated with lower debt levels and lower interest rates. Results for the second quarter of 2001 were impacted by production difficulties and increased costs at the Company's West Elk mine in Colorado caused by high methane levels and by production difficulties at the Samples surface operation in West Virginia caused by a sandstone intrusion into the coal seam.

Results for the second quarter of 2002 were also impacted by the settlement of certain coal contracts with a customer that was unwinding a portion of its coal supply position and desired to buy-out of the remaining terms of those contracts. The settlements resulted in a pre-tax gain of \$5.6 million. Results for the quarter ended June 30, 2001 were also impacted by the following other items: (1) A \$9.4 million pre-tax insurance settlement as part of the Company's coverage under its property and business interruption policy. The insurance settlement represents the final settlement for losses incurred for the West Elk mine idling. (2) A \$4.6 million pre-tax gain as a result of progress in processing claims associated with the recovery of certain previously paid excise taxes on export sales. The gain stems from an IRS notice during the second quarter of 2000 outlining the procedures for obtaining tax refunds on black lung excise taxes paid by the industry on export sales. The notice was the result of a 1998 federal district court decision that found such taxes to be unconstitutional. Of the \$4.6 million recognized, \$3.1 million represented the interest component of the claim and was recorded as interest income. (3) A \$1.7 million reduction in interest expense primarily associated with the termination of certain interest rate swaps that did not qualify as hedges under the accounting treatment prescribed by FAS 133, "Accounting for Derivative Instruments and Hedging Activities." (4) A pre-tax charge of \$2.0 million for stock-based compensation benefits that may be realized in future periods.

Results at the Samples surface operations for the second quarter of 2002 improved but continued to be hindered as the operation transitioned on to a new permit area and away from the sandstone intrusion first encountered during the second quarter of 2001. The intrusion caused the principal coal seam to thin

which resulted in lower production and higher associated costs from the second quarter of 2001 through the first quarter of 2002. Although the Samples surface operation worked out of the influence of the sandstone channel early in the second quarter of 2002, it was hindered during the quarter by market conditions, mine sequencing issues associated with the delayed issuance of permits that have been received and by isolated geologic issues. During the quarter ended June 30, 2002 and 2001, the Samples surface operation incurred pre-tax operating losses of \$3.1 million and \$5.3 million, respectively. In 2001, the West Elk mine encountered higher-than-expected methane levels following the relocation of its longwall mining system to the eastern section of the mine in late February 2001. The high methane levels reduced production during the second quarter of 2001 which resulted in a pre-tax loss at the operation of \$9.0 million.

Revenues. Total revenues for the quarter ended June 30, 2002 were \$374.5 million, an increase of \$5.9 million from the quarter ended June 30, 2001. The increase was primarily caused by increased pricing on coal shipped during the quarter ended June 30, 2002 compared to the same period in the prior year. Average coal sales realizations on a per ton basis were \$14.40 per ton for the quarter ended June 30, 2002 compared to \$13.14 per ton for the quarter ended June 30, 2001. The increase in the per ton realization was the result of the Company shipping more favorably priced contracts during the second quarter of 2002 as compared to the second quarter of 2001. This increase was partially offset by reduced sales volume caused by the oversupply conditions that existed in the market as described above. The Company shipped 24.9 million tons during the quarter ended June 30, 2002 compared to 26.7 million tons during the quarter ended June 30, 2001.

Income From Equity Investment. Income from the equity investment in Canyon Fuel for the quarter ended June 30, 2002 was a loss of \$0.2 million as compared to income of \$4.2 million during the quarter ended June 30, 2001. The decrease was the result of lower realizations due to an above market price contract reopening to market based rates according to contract terms on December 31, 2001 and recoveries of previously paid property taxes during the quarter ended June 30, 2001. The Company's share of these recoveries is \$2.6 million.

Other Revenues. The increase in other revenues of \$1.6 million in the second quarter of 2002 compared to the second quarter of 2001 was primarily attributable to the settlement of certain coal contracts with a customer that was unwinding a portion of its coal supply position and desired to buy-out of the remaining terms of those contracts. This was partially offset by reduced outlease royalty income during the second quarter of 2002 compared to the second quarter of 2001. In addition, during the second quarter of 2001, the Company amortized a gain on a coal sales contract buy-down that resulted in a pre-tax gain of \$2.5 million. The gain was fully amortized prior to December 31, 2001.

Income From Operations. The following table presents income from operations adjusting for the items discussed above.

	Three Months Ended	
	June 30,	
	2002	2001
	-----	-----
	(in millions)	
Income from operations as reported	\$ 12.3	\$ 12.2
Adjustments to (exclude)/add-back:		
Gain on contract buy-out	(5.6)	-
Gain amortization on contract buy-down	-	(2.5)
Losses at the West Elk mine	-	9.0
West Elk mine insurance recoveries	-	(9.4)
Samples surface operation losses	3.1	5.3
Black lung excise tax recoveries	-	(1.5)
Stock based compensation accrual adjustment	-	2.0
Canyon Fuel property tax recoveries	(2.6)	-
	-----	-----
Adjusted income from operations	\$ 7.2	\$ 15.1
	=====	=====

The decrease in adjusted income from operations is primarily attributable to the Company's planned cut-back of production during the second quarter of 2002 in response to the weak market environment described above. The decision to scale back production during the quarter came after the Company prepared most of the operations to maximize production in order to capitalize on the higher market prices for coal the Company had previously projected for 2002. Therefore, certain costs incurred to maximize production did not result in higher revenues but did increase the cost of coal sales. Cost of coal sales on a per ton basis was \$13.67 per ton for the quarter ended June 30, 2002 compared to \$12.48 per ton for the quarter ended June 30, 2001.

**Selling, General and Administrative Expenses.** Selling, general and administrative expenses declined \$2.0 million, to \$10.1 million, during the second quarter of 2002 when compared to expenses of \$12.0 million in the second quarter of 2001. The decrease is primarily attributable to the stock-based compensation accruals recorded during the second quarter of 2001 as discussed above. The Company did not record any stock based compensation accruals during the three months ended June 30, 2002.

**Amortization of Coal Supply Agreements.** Amortization of coal supply agreements was reduced to \$5.4 million in the quarter ended June 30, 2002, compared to \$7.6 million in the same quarter of 2001. The decrease is a result of the expiration, market re-open, and buy-out of above-market contracts that were valued as assets on the Company's balance sheet and amortized in 2001.

**Interest Expense.** Interest expense decreased by \$0.4 million to \$14.4 million for the second quarter of 2002 as a result of lower debt levels and lower interest rates during the second quarter of 2002 when compared to the second quarter of 2001. The net proceeds from two public stock offerings in the first half of 2001 were used to significantly reduce debt levels. Interest expense during the quarter ended June 30, 2001 was reduced by \$1.7 million associated with the termination of certain interest rate swaps described previously.

**Interest Income.** The decrease in interest income of \$3.1 million was the result of the recognition of the interest component of the black lung excise tax recovery during the second quarter of 2001 described previously.

**Income Taxes.** The Company's effective tax rate is sensitive to changes in estimates of annual profitability and percentage depletion. The income tax benefit recorded in the second quarter of 2002 is primarily the result of the impact of percentage depletion.

**Adjusted EBITDA.** Adjusted EBITDA (income from operations before the effect of net interest expense; income taxes; and depreciation, depletion and amortization of the Company, its subsidiaries and its ownership percentage in its equity investments) was \$62.7 million for the current quarter compared to \$68.3 million for the second quarter of 2001. The decrease in adjusted EBITDA was primarily attributable to a \$4.4 million decrease in income from equity investment in Canyon Fuel. Adjusted EBITDA should not be considered in isolation or as an alternative to net income, operating income or cash flows from operations or as a measure of a company's profitability, liquidity or performance under generally accepted accounting principles.

Six Months Ended June 30, 2002, Compared  
to Six Months Ended June 30, 2001

**Net Income (Loss).** The net loss for the six months ended June 30, 2002 was \$5.3 million compared to net income of \$6.9 million for the six months ended June 30, 2001. Results for the six months ended June 30, 2002 were negatively impacted by the current state of oversupply in the coal market that resulted from an extremely mild winter and a period of economic weakness that dampened electricity demand. As a result, during the six months ended June 30, 2002 the Company reduced the rate of production from planned levels at its mining operations. In addition, as described below, the Company continued to be negatively impacted by production difficulties at its Samples surface operation in West Virginia. Partially offsetting these negative items in the six months ended June 30, 2002 were higher contract prices for coal shipped during the period compared to the same period in the prior year and reduced interest expense associated with lower debt levels and lower interest rates. Results for the six months ended June 30, 2001 were impacted by production difficulties and increased costs at the Company's West Elk mine in Colorado caused by high methane levels and by production difficulties at the Samples surface operation in West Virginia caused by a sandstone intrusion into the coal seam.

Results for the six months ended June 30, 2002 were also impacted by the settlement of certain coal contracts with a customer that was partially unwinding its coal supply position and desired to buy-out of the remaining terms of those contracts. The settlement resulted in a pre-tax gain of \$5.6 million. Results for the six months ended June 30, 2001 were also impacted by the following other items: (1) A \$9.4 million pre-tax insurance settlement as part of the Company's coverage under its property and business interruption policy. The insurance settlement represents the final settlement for losses incurred for the West Elk mine idling. (2) A \$4.6 million pre-tax gain as a result of progress in processing claims associated with the recovery of certain previously paid excise taxes on export sales. The gain stems from an IRS notice during the second quarter of 2000 outlining the procedures for obtaining tax refunds on black lung excise taxes paid by the industry on export sales. The notice was the result of a 1998 federal district court decision that found such taxes to be unconstitutional. Of the \$4.6 million recognized, \$3.1 million represented the interest component of the claim and was recorded as interest income. (3) A \$3.5 million pre-tax gain resulting from the reduction in the amount of expected reclamation work at the Company's idle mine properties resulting from permit revisions. (4) A \$1.7 million reduction in interest expense primarily associated with the termination of certain interest rate swaps that did not qualify as hedges under the accounting treatment prescribed by FAS 133, "Accounting for Derivative Instruments and Hedging Activities." (5) A pre-tax charge of \$8.3 million for stock-based compensation benefits that may be realized in future periods.

Results at the Samples surface operations in the six months ended June 30, 2002 continued to be hindered as the operation transitioned into a new permit area and away from the sandstone intrusion first encountered during the second quarter of 2001. The intrusion caused the principal coal seam to thin which resulted in lower production and higher associated costs from the second quarter of 2001 through the first quarter of 2002. Although the Samples surface operation worked out of the influence of the sandstone channel early in the second quarter of 2002, it was hindered during the quarter by market conditions, mine sequencing issues associated with the delayed issuance of permits that have been received and by isolated geologic issues. During the six months ended June 30, 2002 and 2001, the Samples surface operation incurred pre-tax operating losses of \$7.5 million and \$3.9 million, respectively. In 2001, the West Elk mine encountered higher-than-expected methane levels following the relocation of its longwall mining system to the eastern section of the mine in late February 2001. The high methane levels reduced production during the six months ended June 30, 2001 which resulted in a pre-tax loss at the operation of \$10.8 million.

Revenues. Total revenues for the six months ended June 30, 2002 were \$742.9 million, a decrease of \$7.1 million from the six months ended June 30, 2001. The decrease was caused primarily by reduced sales caused by the oversupply conditions that existed in the market as described above. The Company shipped 49.6 million tons during the six months ended June 30, 2002 compared to 53.9 million tons during the six months ended June 30, 2001. Average coal sales realizations on a per ton basis were \$14.46 per ton for the six months ended June 30, 2002 compared to \$13.19 per ton for the six months ended June 30, 2001. The increase in the per ton realization was the result of the Company shipping more favorably priced contracts during the first six months of 2002 as compared to the first six months of 2001.

Income From Equity Investment. Income from the equity investment in Canyon Fuel during the six months ended June 30, 2002 was \$1.1 million as compared to \$10.3 million during the six months ended June 30, 2001. The decrease was the result of lower realizations due to an above market price contract reopening to market based rates according to contract terms at December 31, 2001 and recoveries of previously paid property taxes during the six months ended June 30, 2001. The Company's share of these recoveries is \$2.6 million.

Other Revenues. The decrease in other revenues of \$5.2 million in the six months ended June 30, 2002 compared to the six months ended June 30, 2001 was primarily attributable to additional sales of assets during the six months ended June 30, 2001. These asset sales resulted in a pre-tax gain of \$3.9 million in the six months ended June 30, 2001 compared to \$0.6 million during the six months ended June 30, 2002. In addition, during the six months ended June 30, 2001, the Company amortized a gain on a coal sales contract buy-down that resulted in \$4.9

million of pre-tax income. The gain was fully amortized prior to December 31, 2001. The six months ended June 20, 2002 was also affected by the settlement of certain coal contracts with a customer that was unwinding its coal supply position and desired to buy-out of the remaining terms of those contracts described above.

Income From Operations. The following table presents income from operations adjusting for the items discussed above.

	Six Months Ended June 30,	
	2002	2001
	(in millions)	
Income from operations as reported	\$ 11.0	\$ 38.4
Adjustments to (exclude)/add-back:		
Gain on contract buy-out	(5.6)	-
Gain amortization on contract buydown	-	(4.9)
Losses at the West Elk mine	-	10.8
West Elk mine insurance recoveries	-	(9.4)
Samples surface operation losses	7.5	3.9
Land sales	(0.6)	(3.9)
Reclamation adjustment	-	(3.5)
Stock based compensation accrual adjustment	-	8.3
Canyon Fuel property tax recoveries	(2.6)	-
Adjusted income from operations	\$ 9.7	\$ 39.7

The decrease in adjusted income from operations is primarily attributable to the Company's planned cut-back of production during the six months ended June 30, 2002 in response to the weak market environment described above. The decision to scale back production during the period came after the Company prepared most of the operations to maximize production in order to capitalize on the higher market prices for coal the Company had previously projected for 2002. Therefore, certain costs incurred to maximize production did not result in higher revenues but did increase the cost of coal sales. Cost of coal sales on a per ton basis was \$13.87 per ton for the six months ended June 30, 2002 compared to \$12.29 per ton for the six months ended June 30, 2001.

Selling, General and Administrative Expenses. Selling, general and administrative expenses declined \$5.9 million, to \$19.9 million, during the six months ended June 30, 2002 when compared to expenses of \$25.8 million during the six months ended June 30, 2001. The decrease is primarily attributable to the stock-based compensation accruals recorded during the period as discussed above. The Company did not record any stock based compensation accruals during the six months ended June 30, 2002.

Amortization of Coal Supply Agreements. Amortization of coal supply agreements was reduced to \$10.5 million for the six months ended June 30, 2002, compared to \$15.2 million in the same period of 2001. The decrease is a result of the expiration and buy-out of above-market contracts that were valued as assets on the Company's balance sheet and amortized in 2001.

Other Expenses. Other expenses increased to \$13.4 million during the six months ended June 30, 2002 from \$8.5 million for the same period of 2001 primarily due to the cost of terminating certain contractual obligations for the purchase or sale of coal.

Interest Expense. Interest expense decreased by \$9.7 million to \$26.4 million during the six months ended June 30, 2002 as a result of lower debt levels and lower interest rates during the six months ended June 30, 2002 when compared to the same period in 2001. The net proceeds from two public stock offerings in the first half of 2001 were used to significantly reduce debt levels. Interest expense during the six months ended June 30, 2001 was reduced by \$1.7 million associated with the termination of certain interest rate swaps described previously.

Interest Income. The decrease in interest income of \$3.1 million was the result of the recognition of the interest component of the black lung excise tax recovery during the six months ended June 30, 2001 described previously.

Income Taxes. The Company's effective tax rate is sensitive to changes in estimates of annual profitability and percentage depletion. The income tax benefit recorded in the six months ended June 30, 2002 is primarily the result of the impact of percentage depletion.

Adjusted EBITDA. Adjusted EBITDA (income from operations before the effect of net interest expense; income taxes; and depreciation, depletion and amortization of the Company, its subsidiaries and its ownership percentage in its equity investments) was \$111.8 million during the six months ended June 30, 2002 compared to \$148.6 million for the same period of 2001. The decrease in adjusted EBITDA was primarily attributable to the \$27.4 million decrease in income from operations resulting from the reduction in production levels and the Samples production issues, both of which are discussed above.

#### OUTLOOK

Production Levels. The Company reduced its rate of coal production at its eastern and western operations by approximately 7% during the first half of 2002. These actions were taken in response to unfavorable spot coal markets following an extremely mild winter and a period of economic weakness that dampened electricity demand. The Company plans to increase its rate of production when markets rebound. Although the timing of any recovery in coal markets remains uncertain, there have been indications that prices may return to more favorable levels during the last half of 2002 or early part of 2003. These indications include more normal summer weather patterns and an overall decrease in coal production.

West Virginia Operations. On May 8, 2002, in *Kentuckians for the Commonwealth v. Rivenburgh*, the U.S. District Court for the Southern District of West Virginia enjoined the Huntington, West Virginia office of the U.S. Army Corps of Engineers from issuing any new ss.404 Clean Water Act permits that authorize the placement of rock and soil into channels that comprise waters of the United States. This process is used primarily in surface mining operations where layers of dirt and rock are removed to expose the underlying coal seam, although underground mining operations also generate some of this material. The excess material is then placed into "valley fills". The court reached its conclusion on the basis that the material constituted "waste" which may not be disposed of in valley fills under Corps-issued permits.

Following the issuance of the court's May 8, 2002 order, the plaintiff in the *Kentuckians* case filed a motion for further injunctive relief, requesting that the court require the Huntington, West Virginia office of the U.S. Army Corps of Engineers to revoke the Section 404 valley fill permit identified in the plaintiff's complaint. In addition, various defendants and intervenors filed motions seeking a clarification of the court's order, a stay pending appeal, and a dismissal for failure to join a necessary party. In response to the defendants' motion for clarification, the court decided that its injunction applies to any fill activity that does not have a "constructive primary purpose," citing as an example fills used solely for the disposal of waste. The court noted that such fills could include not only valley fills, but also other mining activities such as refuse impoundments, fills from standard contour or surface mines, slurry impoundments and coal refuse disposal areas or fills related to mine sites with "approximate original contour" waivers. The court noted, however, that determining whether a particular fill has a "constructive primary purpose" is up to the technical expertise of the U.S. Army Corps of Engineers. The court denied both the defendants' motion for stay pending appeal and their motion for dismissal. For further discussion of this case, see *Certain Trends and Uncertainties - Environmental and Regulatory Factors - The Clean Water Act* beginning on page 21.

The Company idled its Dal-Tex operation on July 23, 1999 as a result of an adverse ruling in prior litigation on the issue of valley fills. This ruling was later reversed on appeal; however, as of the date of the 2002 injunction described above, the Company had not yet completed the process necessary to obtain the ss.404 permits for the mine. Therefore, the Company may not be able to re-open its Dal-Tex surface mining operation unless the current injunction is reversed on appeal and it is able to obtain all necessary permits or its permit application meets the "constructive primary purpose" test. If the current litigation is favorably resolved and the Company is able to obtain the necessary permits, it may determine to reopen the mine subject to then-existing market conditions. Unless reversed, the ruling may also affect the Company's ability to sustain its current mining operations or open new mines.

Previously, the Company had disclosed that longwall mineable reserves at Mingo Logan were likely to be exhausted during 2002. As a result of improvements to the mine plan, the mine is not expected to exhaust its longwall mineable reserves until 2006, subject to permit modifications.

Low-Sulfur Coal Producer. The Company continues to believe that it is well positioned to capitalize on the continuing growth in demand for low-sulfur coal to produce electricity. One hundred percent of the Company's current coal production and approximately 90% of its reserves are low in sulfur. Approximately 65% of the Company's coal reserves are compliance quality, which means that they meet Phase II standards of the Clean Air Act without application of expensive scrubbing technology. With Phase II now in effect, compliance coal has captured a growing share of United States coal demand and commands a higher price in the marketplace than high-sulfur coal.

Chief Objectives. The Company continues to focus on taking steps designed to improve earnings, strengthen cash generation, improve productivity and reduce costs at its large-scale mines, while building on its leading position in its target coal-producing basins, the Powder River Basin and the Central Appalachian Basin.

Natural Resource Partners L.P. The Company announced on April 19, 2002 that it had created a limited partnership, Natural Resource Partners L.P., with three private affiliated companies: Western Pocahontas Properties Limited Partnership, Great Northern Properties Limited Partnership and New Gauley Coal Corporation (collectively, the "WPP Group"). Natural Resource Partners was formed to engage principally in the business of owning and managing coal royalty properties in the three major coal-producing regions of the United States: Appalachia, the Illinois Basin and the Western United States. A Registration Statement on Form S-1 has been filed with the Securities and Exchange Commission relating to a proposed underwritten initial public offering of common units representing limited partner interests in the partnership including 1,901,250 common units anticipated to be sold by the Company. The Company will contribute approximately 454 million tons of its 3.4 billion tons of total coal reserves to Natural Resource Partners in exchange for its ownership interest in the partnership.

#### LIQUIDITY AND CAPITAL RESOURCES

The following is a summary of cash provided by or used in each of the indicated types of activities during the six months ended June 30, 2002 and 2001:

	2002	2001
	-----	-----
	(in thousands)	
Cash provided by (used in):		
Operating activities	\$ 97,471	\$ 84,944
Investing activities	(113,964)	(80,154)
Financing activities	10,946	(8,654)

Cash provided by operating activities increased during the six months ended June 30, 2002 when compared to the same period in 2001 in spite of lower income and the build in inventories primarily as a result of reduced working capital requirements other than inventories in the first half of 2002.

Cash used in investing activities during the six months ended June 30, 2002 increased over the same period in 2001 due to higher capital expenditures during the first half of 2002 as the Company increased capital expenditures to maintain existing infrastructure and prepared to increase production for anticipated higher market prices. During January of 2001 and 2002, the Company made the third and fourth, respectively, of five annual \$31.6 million payments under the Thundercloud federal lease, which is part of the Black Thunder mine in Wyoming. The remaining payment is due in January 2003.

Cash provided by financing activities was \$10.9 million during the six months ended June 30, 2002 compared to cash used in financing activities of \$8.7 million during the six months ended June 30, 2001. The cash provided by financing activities during the first half of 2002 reflects borrowings on the Company's revolver and line of credit caused in part by higher capital

expenditures during the first half of 2002, while cash used in financing activities during the first half of 2001 reflects the pay-down of \$382.8 million of debt primarily from a February 2001 and April 2001 issuance of common stock which resulted in proceeds of \$372.2 million. In addition, during the second quarter of 2002, the Company acquired certain assets that were held under a capital lease arrangement for a payment of \$6.5 million. Also during the second quarter of 2002, the Company entered into a sale and leaseback of equipment that resulted in proceeds of \$9.2 million.

The Company generally satisfies its working capital requirements and funds its capital expenditures and debt-service obligations with cash generated from operations. The Company believes that cash generated from operations and its borrowing capacity will be sufficient to meet its working capital requirements, anticipated capital expenditures and scheduled debt payments for at least the next several years. The Company's ability to satisfy debt service obligations, to fund planned capital expenditures, to make acquisitions and to pay dividends will depend upon its future operating performance, which will be affected by prevailing economic conditions in the coal industry and financial, business and other factors, some of which are beyond the Company's control.

Expenditures for property, plant and equipment were \$96.1 million for the six months ended June 30, 2002, compared to \$64.6 million for the six months ended June 30, 2001. Capital expenditures are made to improve and replace existing mining equipment, expand existing mines, develop new mines and improve the overall efficiency of mining operations. It is anticipated that future capital expenditures will be funded by available cash and existing credit facilities.

At June 30, 2002, the Company had \$40.5 million in letters of credit outstanding which, when combined with borrowings under the revolver, allowed for \$194.5 million of available borrowings under the Company's revolving credit facility.

On April 18, 2002, the Company and Arch Western completed a refinancing of their existing credit facilities. The new credit facilities include five- and six-year non-amortizing term loans totaling \$675.0 million at Arch Western and a five-year revolving credit facility totaling \$350.0 million for the Company. The five-year non-amortizing term loan at Arch Western is for \$150.0 million while the six-year non-amortizing term loan is for \$525.0 million. The rate of interest on borrowings under both of the credit facilities is a floating rate based on LIBOR. The Company's credit facility is secured by ownership interests in substantially all of its subsidiaries, except its ownership interests in Arch Western and its subsidiaries. The Arch Western credit facility is secured by substantially all of its subsidiaries, but is not guaranteed by the Company.

Financial covenants contained in the Company's new credit facilities consist of a maximum leverage ratio, a minimum fixed charge coverage ratio and a minimum net worth test. The leverage ratio requires that the Company not permit the ratio of total indebtedness at the end of any calendar quarter to adjusted EBITDA for the four quarters then ended exceed a specified amount. The fixed charge coverage ratio requires that the Company not permit the ratio of the Company's adjusted EBITDA plus lease expense to interest expense plus lease expense for the four quarters then ended to be less than a specified amount. The net worth test requires that the Company not permit its net worth to be less than a specified amount plus 50% of cumulative net income.

The Company periodically establishes uncommitted lines of credit with banks. These agreements generally provide for short-term borrowings at market rates. At June 30, 2002, there were \$20.0 million of such agreements in effect, of which \$5.6 million were outstanding. The Company can also issue an additional \$469.5 million in public debt and equity securities under a shelf registration statement.

The Company is exposed to market risk associated with interest rates. At June 30, 2002, debt included \$795.6 million of floating-rate debt, for which the rate of interest is a rate based on LIBOR and current market rates for bank lines of credit. To manage this exposure, the Company enters into interest-rate swap agreements to modify the interest-rate characteristics of outstanding Company debt. At June 30, 2002, the Company had interest-rate swap agreements having a total notional value of \$425.0 million. These swap agreements are used to convert variable-rate debt to fixed-rate debt. Under these swap agreements, the Company pays a weighted average fixed rate of 6.65% (before the credit spread over LIBOR) and receives a weighted average variable rate based upon 30-day and

90-day LIBOR. The Company accrues amounts to be paid or received under interest-rate swap agreements over the lives of the agreements as adjustments to interest expense, thereby adjusting the effective interest rate on the Company's debt. After taking into consideration interest-rate swap agreements, debt exposed to variable rates was \$370.6 million. Gains and losses on terminations of interest-rate swap agreements are deferred on the Company's balance sheet (in other long-term liabilities) and amortized as an adjustment to interest expense over the original term of the terminated swap agreement as if it were still in place. The remaining terms of the swap agreements at June 30, 2002 ranged from 2 to 47 months. All instruments are entered into for other than trading purposes.

The Company is also exposed to commodity price risk related to its purchase of diesel fuel. The Company enters into heating oil swaps to substantially eliminate volatility in the price of diesel fuel purchased for its operations. The swap agreements essentially fix the price paid for diesel fuel by requiring the Company to pay a fixed heating oil price and receive a floating heating oil price. Gains and losses on terminations of heating oil swap agreements are deferred on the balance sheet (in other long-term liabilities) and amortized as an adjustment to diesel fuel cost over the original term of the terminated heating oil swap agreement as if it were still in place.

The discussion below presents the sensitivity of the market value of the Company's financial instruments to selected changes in market rates and prices. The range of changes reflects the Company's view of changes that are reasonably possible over a one-year period. Market values are the present value of projected future cash flows based on the market rates and prices chosen. The major accounting policies for these instruments are described in Note 1 to the consolidated financial statements of the Company as of and for the year ended December 31, 2001 as filed on its Annual Report on Form 10-K with the Securities and Exchange Commission.

Changes in interest rates have different impacts on the fixed-rate and variable-rate portions of the Company's debt portfolio. A change in interest rates on the fixed portion of the debt portfolio impacts the net financial instrument position but has no impact on interest incurred or cash flows. A change in interest rates on the variable portion of the debt portfolio impacts the interest incurred and cash flows but does not impact the net financial instrument position. The sensitivity analysis related to the fixed portion of the Company's debt portfolio assumes an instantaneous 100-basis-point move in interest rates from their levels at June 30, 2002, with all other variables held constant. A 100-basis-point decrease in market interest rates would result in a \$7.4 million increase in the fair value of the fixed portion of the debt at June 30, 2002. Based on the variable-rate debt included in the Company's debt portfolio as of June 30, 2002, after considering the effect of the swap agreements, a 100-basis-point increase in interest rates would result in an annualized additional \$3.7 million of interest expense incurred based on June 30, 2002 debt levels. Similarly, relative to the Company's diesel hedge position, at June 30, 2002, a \$.05 per gallon decrease in the price of heating oil would result in a \$0.8 million increase in the fair value of the financial position of the heating oil swap.

#### CONTINGENCIES

##### Reclamation.

The federal Surface Mining Control and Reclamation Act of 1977 ("SMCRA") and similar state statutes require that mine property be restored in accordance with specified standards and an approved reclamation plan. The Company accrues for the costs of final mine closure reclamation over the estimated useful mining life of the property. These costs relate to reclaiming the pit and support acreage at surface mines and sealing portals at deep mines. Other costs of final mine closure common to surface and underground mining are related to reclaiming refuse and slurry ponds, eliminating sedimentation and drainage control structures and dismantling or demolishing equipment or buildings used in mining operations. The Company also accrues for significant reclamation that is completed during the mining process prior to final mine closure. The establishment of the final mine closure reclamation liability and the other ongoing reclamation liabilities are based upon permit requirements and require various estimates and assumptions, principally associated with costs and productivities.

The Company reviews its entire environmental liability periodically and makes necessary adjustments, including permit changes and revisions to costs and productivities to reflect current experience. The Company's management believes it is making adequate provisions for all expected reclamation and other associated costs.

##### Legal Contingencies.

The Company is a party to numerous claims and lawsuits with respect to various matters, including those discussed below. The Company provides for costs related to contingencies, including environmental matters, when a loss is probable and

the amount is reasonably determinable. After conferring with counsel, it is the opinion of management that the ultimate resolution of these claims, to the extent not previously provided for, will not have a material adverse effect on the consolidated financial condition, results of operations or liquidity of the Company.

Cumulative Hydrologic Impact Assessment ("CHIA") Litigation. On January 20, 2000, two environmental organizations, the Ohio Valley Environmental Coalition and the Hominy Creek Watershed Association, filed suit against the West Virginia DEP in U.S. District Court in Huntington, West Virginia. In addition to allegations that the West Virginia DEP violated state law and provisions of the Clean Water Act, the plaintiffs allege that the West Virginia DEP's issuance of permits for surface and underground coal mining has violated certain non-discretionary duties mandated by SMCRA. Specifically, the plaintiffs allege that the West Virginia DEP has failed to require coal operators seeking permits to conduct water monitoring to verify stream flows and ascertain water quality, to always include certain water quality information in their permit applications and to analyze the probable hydrologic consequences of their operations. The plaintiffs also allege that the West Virginia DEP has failed to analyze the cumulative hydrologic impact of mining operations on specific watersheds.

The plaintiffs sought an injunction to prohibit the West Virginia DEP from issuing any new permits which fail to comply with all of the elements identified in their complaint. The complaint identified, and sought to enjoin, three pending permits sought by the Company in connection with its Mingo Logan operations in order to continue existing surface mining operations at the Phoenix reserve. On January 15, 2001, the West Virginia DEP notified the plaintiffs that the Company had completed all steps necessary to obtain the permits. On March 8, 2001, the Court denied the plaintiffs' motion for a preliminary injunction seeking to enjoin the DEP's decision to issue the permits. The Company subsequently received some of the permits necessary to continue operating the surface mine. If the plaintiffs ultimately prevail in this litigation, the Company's ability to mine surface coal at Mingo Logan could be adversely affected, and depending upon the length of the suspension, the effect could be material. This matter does not affect Mingo Logan's existing permits related to its underground operations.

#### CERTAIN TRENDS AND UNCERTAINTIES

##### Substantial Leverage - Variable Interest Rate - Covenants.

As of June 30, 2002, the Company had outstanding consolidated indebtedness of \$797.1 million, representing approximately 59% of the Company's capital employed. Despite making substantial progress in reducing debt, the Company continues to have significant debt-service obligations, and the terms of its credit agreements limit its flexibility and result in a number of limitations on the Company. The Company also has significant lease and royalty obligations. The Company's ability to satisfy debt service, lease and royalty obligations and to effect any refinancing of its indebtedness will depend upon future operating performance, which will be affected by prevailing economic conditions in the markets that the Company serves as well as financial, business and other factors, many of which are beyond the Company's control. The Company may be unable to generate sufficient cash flow from operations and future borrowings, or other financings may be unavailable in an amount sufficient to enable it to fund its debt service, lease and royalty payment obligations or its other liquidity needs.

The Company's relative amount of debt and the terms of its credit agreements could have material consequences to its business, including, but not limited to: (i) making it more difficult to satisfy debt covenants and debt service, lease payment and other obligations; (ii) making it more difficult to pay quarterly dividends as the Company has in the past; (iii) increasing the Company's vulnerability to general adverse economic and industry conditions; (iv) limiting the Company's ability to obtain additional financing to fund future acquisitions, working capital, capital expenditures or other general corporate requirements; (v) reducing the availability of cash flows from operations to fund acquisitions, working capital, capital expenditures or other general corporate purposes; (vi) limiting the Company's flexibility in planning for, or reacting to, changes in the Company's business and the industry in which the Company competes; or (vii) placing the Company at a competitive disadvantage when compared to competitors with less relative amounts of debt.

After taking into consideration the Company's interest-rate swaps which convert the Company's variable rate debt to fixed, approximately 46% of the Company's indebtedness bears interest at variable rates that are linked to short-term interest rates. If interest rates rise, the Company's costs relative to those obligations would also rise.

Terms of the Company's credit facilities and leases contain financial and other covenants that create limitations on the Company's ability to, among other things, effect acquisitions or dispositions and borrow additional funds, and require the Company to, among other things, maintain various financial ratios and comply with various other financial covenants. Failure by the Company to comply with such covenants could result in an event of default under these agreements which, if not cured or waived, would enable the Company's lenders to declare amounts borrowed due and payable, or otherwise result in unanticipated costs.

#### Losses.

The Company reported a net loss of \$5.3 million for the six months ended June 30, 2002. The losses in the first half of 2002 were primarily due to the Company's decision to scale back production during the first half of the year in response to a weak market environment. The decision to scale back production came after the Company had prepared most of the operations to maximize production in order to capitalize on higher market prices for coal the Company had previously projected for 2002. Therefore, certain costs incurred to maximize production did not result in higher revenues but did increase cost of coal sales.

Because the coal mining industry is subject to significant regulatory oversight and due to the possibility of continued adverse pricing trends or other industry trends beyond the Company's control, the Company may suffer losses in the future if legal and regulatory rulings, mine idlings and closures, adverse pricing trends or other factors affect the Company's ability to mine and sell coal profitably.

#### Environmental and Regulatory Factors.

The coal mining industry is subject to regulation by federal, state and local authorities on matters such as:

- o the discharge of materials into the environment;
- o employee health and safety;
- o mine permits and other licensing requirements;
- o reclamation and restoration of mining properties after mining is completed;
- o management of materials generated by mining operations;
- o surface subsidence from underground mining;
- o water pollution;
- o legislatively mandated benefits for current and retired coal miners;
- o air quality standards;
- o protection of wetlands;
- o endangered plant and wildlife protection;
- o limitations on land use;
- o storage of petroleum products and substances that are regarded as hazardous under applicable laws; and
- o management of electrical equipment containing polychlorinated biphenyls, or PCBs.

In addition, the electric generating industry, which is the most significant end-user of coal, is subject to extensive regulation regarding the environmental impact of its power generation activities, which could affect demand for the Company's coal. The possibility exists that new legislation or regulations may be adopted or that the enforcement of existing laws could become more stringent, either of which may have a significant impact on the Company's mining operations or its customers' ability to use coal and may require the Company or its customers to change operations significantly or incur substantial costs.

While it is not possible to quantify the expenditures incurred by the Company to maintain compliance with all applicable federal and state laws, those costs have been and are expected to continue to be significant. The Company posts performance bonds pursuant to federal and state mining laws and regulations for the estimated costs of reclamation and mine closing, including the cost of treating mine water discharge when necessary. Compliance with these laws has substantially increased the cost of coal mining for all domestic coal producers.

Clean Air Act. The federal Clean Air Act and similar state and local laws, which regulate emissions into the air, affect coal mining and processing operations

primarily through permitting and emissions control requirements. The Clean Air Act also indirectly affects coal mining operations by extensively regulating the emissions from coal-fired industrial boilers and power plants, which are the largest end-users of the Company's coal. These regulations can take a variety of forms, as explained below.

The Clean Air Act imposes obligations on the Environmental Protection Agency, or EPA, and the states to implement regulatory programs that will lead to the attainment and maintenance of EPA-promulgated ambient air quality standards, including standards for sulfur dioxide, particulate matter, nitrogen oxides and ozone. Owners of coal-fired power plants and industrial boilers have been required to expend considerable resources in an effort to comply with these ambient air standards. Significant additional emissions control expenditures will be needed in order to meet the current national ambient air standard for ozone. In particular, coal-fired power plants will be affected by state regulations designed to achieve attainment of the ambient air quality standard for ozone. Ozone is produced by the combination of two precursor pollutants: volatile organic compounds and nitrogen oxides. Nitrogen oxides are a by-product of coal combustion. Accordingly, emissions control requirements for new and expanded coal-fired power plants and industrial boilers will continue to become more demanding in the years ahead.

In July 1997, the EPA adopted more stringent ambient air quality standards for particulate matter and ozone. In a February 2001 decision, the U.S. Supreme Court largely upheld the EPA's position, although it remanded the EPA's ozone implementation policy for further consideration. On remand, the Court of Appeals for the D.C. Circuit affirmed EPA's adoption of these more stringent ambient air quality standards. As a result of the finalization of these standards, states that are not in attainment for these standards will have to revise their State Implementation Plans to include provisions for the control of ozone precursors and/or particulate matter. Revised State Implementation Plans could require electric power generators to further reduce nitrogen oxide and particulate matter emissions. The potential need to achieve such emissions reductions could result in reduced coal consumption by electric power generators. Thus, future regulations regarding ozone, particulate matter and other pollutants could restrict the market for coal and the development of new mines by the Company. This in turn may result in decreased production by the Company and a corresponding decrease in the Company's revenues. Although the future scope of these ozone and particulate matter regulations cannot be predicted, future regulations regarding these and other ambient air standards could restrict the market for coal and the development of new mines.

Furthermore, in October 1998, the EPA finalized a rule that will require 19 states in the Eastern United States that have ambient air quality problems to make substantial reductions in nitrogen oxide emissions by the year 2004. To achieve these reductions, many power plants would be required to install additional control measures. The installation of these measures would make it more costly to operate coal-fired power plants and, depending on the requirements of individual state implementation plans, could make coal a less attractive fuel.

Along with these regulations addressing ambient air quality, the EPA has initiated a regional haze program designed to protect and to improve visibility at and around National Parks, National Wilderness Areas and International Parks. This program restricts the construction of new coal-fired power plants whose operation may impair visibility at and around federally protected areas. Moreover, this program may require certain existing coal-fired power plants to install additional control measures designed to limit haze-causing emissions, such as sulfur dioxide, nitrogen oxides and particulate matter. By imposing limitations upon the placement and construction of new coal-fired power plants, the EPA's regional haze program could affect the future market for coal.

Additionally, the U.S. Department of Justice, on behalf of the EPA, has filed lawsuits against several investor-owned electric utilities and brought an administrative action against one government-owned electric utility for alleged violations of the Clean Air Act. The EPA claims that these utilities have failed to obtain permits required under the Clean Air Act for alleged major modifications to their power plants. The Company supplies coal to some of the currently affected utilities, and it is possible that other of the Company's customers will be sued. These lawsuits could require the utilities to pay penalties and install pollution control equipment or undertake other emission reduction measures, which could adversely impact their demand for coal.

Other Clean Air Act programs are also applicable to power plants that use the Company's coal. For example, the acid rain control provisions of Title IV of the Clean Air Act require a reduction of sulfur dioxide emissions from power plants.

Because sulfur is a natural component of coal, required sulfur dioxide reductions can affect coal mining operations. Title IV imposes a two phase approach to the implementation of required sulfur dioxide emissions reductions. Phase I, which became effective in 1995, regulated the sulfur dioxide emissions levels from 261 generating units at 110 power plants and targeted the highest sulfur dioxide emitters. Phase II, implemented January 1, 2000, made the regulations more stringent and extended them to additional power plants, including all power plants of greater than 25 megawatt capacity. Affected electric utilities can comply with these requirements by:

- o burning lower sulfur coal, either exclusively or mixed with higher sulfur coal;
- o installing pollution control devices such as scrubbers, which reduce the emissions from high sulfur coal;
- o reducing electricity generating levels; or
- o purchasing or trading emission credits.

Specific emissions sources receive these credits that electric utilities and industrial concerns can trade or sell to allow other units to emit higher levels of sulfur dioxide. Each credit allows its holder to emit one ton of sulfur dioxide.

In addition to emissions control requirements designed to control acid rain and to attain the national ambient air quality standards, the Clean Air Act also imposes standards on sources of hazardous air pollutants. Although these standards have not yet been extended to coal mining operations, the EPA recently announced that it will regulate hazardous air pollutants from coal-fired power plants. Under the Clean Air Act, coal-fired power plants will be required to control hazardous air pollution emissions by no later than 2009. These controls are likely to require significant new improvements in controls by power plant owners. The most prominently targeted pollutant is mercury, although other by-products of coal combustion may be covered by future hazardous air pollutant standards for coal combustion sources.

Other proposed initiatives may have an effect upon coal operations. One such proposal is the Bush Administration's recently announced Clear Skies Initiative. As proposed, this initiative is designed to reduce emissions of sulfur dioxide, nitrogen oxides, and mercury from power plants. Other so-called multi-pollutant bills, which could regulate additional air pollutants, have been proposed by various members of Congress. While the details of all of these proposed initiatives vary, there appears to be a movement towards increased regulation of a number of air pollutants. Were such initiatives enacted into law, power plants could choose to shift away from coal as a fuel source to meet these requirements.

Mine Health and Safety Laws. Stringent safety and health standards have been imposed by federal legislation since the adoption of the Mine Health and Safety Act of 1969. The Mine Safety and Health Act of 1977, which significantly expanded the enforcement of health and safety standards of the Mine Health and Safety Act of 1969, imposes comprehensive safety and health standards on all mining operations. In addition, as part of the Mine Health and Safety Acts of 1969 and 1977, the Black Lung Act requires payments of benefits by all businesses conducting current mining operations to coal miners with black lung and to some survivors of a miner who dies from this disease.

Surface Mining Control And Reclamation Act. SMCRA establishes operational, reclamation and closure standards for all aspects of surface mining as well as many aspects of deep mining. SMCRA requires that comprehensive environmental protection and reclamation standards be met during the course of and upon completion of mining activities. In conjunction with mining the property, the Company is contractually obligated under the terms of their leases to comply with all laws, including SMCRA and equivalent state and local laws. These obligations include reclaiming and restoring the mined areas by grading, shaping, preparing the soil for seeding and by seeding with grasses or planting trees for use as pasture or timberland, as specified in the approved reclamation plan.

SMCRA also requires the Company to submit a bond or otherwise financially secure the performance of its reclamation obligations. The earliest a reclamation bond can be completely released is five years after reclamation has been achieved. Federal law and some states impose on mine operators the responsibility for repairing the property or compensating the property owners for damage occurring on the surface of the property as a result of mine subsidence, a consequence of longwall mining and possibly other mining operations. In addition, the Abandoned Mine Lands Act, which is part of SMCRA, imposes a tax on all current mining operations, the proceeds of which are used to restore mines closed before 1977. The maximum tax is \$0.35 per ton of coal produced from surface mines and \$0.15 per ton of coal produced from underground mines.

The Company also leases some of its coal reserves to third party operators. Under SMCRA, responsibility for unabated violations, unpaid civil penalties and unpaid reclamation fees of independent mine lessees and other third parties could potentially be imputed to other companies that are deemed, according to the regulations, to have "owned" or "controlled" the mine operator. Sanctions against the "owner" or "controller" are quite severe and can include civil penalties, reclamation fees and reclamation costs. The Company is not aware of any currently pending or asserted claims against it asserting that it "owns" or "controls" any of its lessees' operations.

On March 29, 2002, the U.S. District Court for the District of Columbia issued a ruling that could restrict underground mining activities conducted in the vicinity of public roads, within a variety of federally protected lands, within national forests and within a certain proximity of occupied dwellings. The lawsuit, Citizens Coal Council v. Norton, was filed in February 2000 to challenge regulations issued by the Department of Interior providing, among other things, that subsidence and underground activities that may lead to subsidence are not surface mining activities within the meaning of SMCRA. SMCRA generally contains restrictions and certain prohibitions on the locations where surface mining activities can be conducted. The District Court entered summary judgment upon the plaintiff's claims that the Secretary of the Interior's determination violated SMCRA. By order dated April 9, 2002, the court remanded the regulations to the Secretary of the Interior for reconsideration.

The significance of this decision for the coal mining industry remains unclear because this ruling is subject to appellate review. The Department of Interior and the National Mining Association, a trade group that intervened in this action, sought a stay of the order pending appeal to the U.S. Court of Appeals for the District of Columbia Circuit and the stay was granted. If the District Court's decision is not overturned, or if some legislative solution is not enacted, this ruling could have a material adverse effect on all coal mine operations that utilize underground mining techniques, including those of the Company. While it still may be possible to obtain permits for underground mining operations in these areas, the time and expense of that permitting process are likely to increase significantly.

Framework Convention on Global Climate Change. The United States and more than 160 other nations are signatories to the 1992 Framework Convention on Global Climate Change, commonly known as the Kyoto Protocol, that is intended to limit or capture emissions of greenhouse gases such as carbon dioxide and methane. The U.S. Senate has neither ratified the treaty commitments, which would mandate a reduction in U.S. greenhouse gas emissions, nor enacted any law specifically controlling greenhouse gas emissions and the Bush Administration has withdrawn support for this treaty. Nonetheless, future regulation of greenhouse gases could occur either pursuant to future U.S. treaty obligations or pursuant to statutory or regulatory changes under the Clean Air Act. Efforts to control greenhouse gas emissions could result in reduced demand for coal if electric power generators switch to lower carbon sources of fuel.

Clean Water Act. Section 301 of the Clean Water Act prohibits the discharge of a pollutant from a point source into navigable waters except in accordance with a permit issued under either Section 402 or Section 404 of the Clean Water Act. Navigable waters are broadly defined to include streams, even those that are not navigable in fact, and may include wetlands.

All mining operations in Appalachia generate excess material, which must be placed in fills in adjacent valleys and hollows. Likewise, coal refuse disposal areas and coal processing slurry impoundments are located in valleys and hollows. Almost all of these areas contain intermittent or perennial streams, which are considered navigable waters. An operator must secure a Clean Water Act permit before filling such streams. For approximately the past twenty-five years, operators have secured Section 404 fill permits to authorize the filling of navigable waters with material from various forms of coal mining. Operators have also obtained permits under Section 404 for the construction of slurry impoundments although the use of these impoundments, including discharges from them requires permits under Section 402. Section 402 discharge permits are generally not suitable for authorizing the construction of fills in navigable waters.

On May 8, 2002, the United States District Court for the Southern District of West Virginia issued an order in *Kentuckians for the Commonwealth v. Rivenburgh* enjoining the Huntington, West Virginia office of the U.S. Army Corps of Engineers from issuing permits under Section 404 of the Clean Water Act for the construction of valley fills for the disposal of overburden from mountaintop mining operations solely for the purpose of waste disposal. These valleys

typically contain streams that, under the Clean Water Act, are considered navigable waters of the United States. The court held that the filling of these waters solely for waste disposal is a violation of the Clean Water Act. The effect of this injunction, if it is not overturned by an appellate court or subsequent legislation, will be to make mountaintop mining uneconomical in those areas subject to the injunction.

The court's injunction also prohibits the issuance of permits authorizing fill activities associated with types of mining activities other than mountaintop mining where the primary purpose or use of those fill activities is the disposal of waste. Such activities might include those associated with slurry impoundments and coal refuse disposal areas. If the injunction is not overturned by an appellate court or subsequent legislation, the Company may not be able to obtain permits in many cases to use these common fill activities, which could render these operations uneconomical.

Following the issuance of the court's May 8, 2002 order, the plaintiff in the Kentuckians case filed a motion for further injunctive relief requesting that the court require the Huntington, West Virginia office of the U.S. Army Corps of Engineers to revoke the Section 404 valley fill permit identified in the plaintiff's complaint. In addition, various defendants and intervenors filed motions seeking a clarification of the court's order, a stay pending appeal, and a dismissal for failure to join a necessary party.

On June 17, 2002, the court ruled on all of the parties' motions. In response to the defendants' motion for clarification, the court decided that its injunction applies to any fill activity that does not have a "constructive primary purpose", citing as an example fills used solely for the disposal of waste. The court noted that such fills could include not only valley fills, but also other mining activities such as refuse impoundments, fills from standard contour or surface mines, or fills related to mine sites with "approximate original contour" waivers. The court noted, however, that determining whether a particular fill has a "constructive primary purpose" is up to the technical expertise of the U.S. Army Corps of Engineers. It also appears that the court would allow the U.S. Army Corps of Engineers to take into consideration post-mining land uses when applying the "constructive primary purpose" test to a particular fill activity. This ruling creates additional uncertainty about how the U.S. Army Corps of Engineers is to apply the "constructive primary purpose" test.

Following its discussion of the motion for clarification, the court addressed and denied both the defendants' motion for stay pending appeal and their motion for dismissal. Along with its denials of the defendants' various motions, the court denied the plaintiff's motion for further injunctive relief. Accordingly, the court did not require the U.S. Army Corps of Engineers to revoke the challenged Section 404 permit. The court based its decision on the grounds that it did not have sufficient factual information to determine whether the particular fill at issue had a "constructive primary purpose".

West Virginia Antidegradation Policy. In January 2002, a number of environmental groups and individuals filed suit in the U.S. District Court for the Southern District of West Virginia to challenge the EPA's approval of West Virginia's antidegradation implementation policy. Under the federal Clean Water Act, state regulatory authorities must conduct an antidegradation review before approving permits for the discharge of pollutants to waters that have been designated as high quality by the state. Antidegradation review involves public and intergovernmental scrutiny of permits and requires permittees to demonstrate that the proposed activities are justified in order to accommodate significant economic or social development in the area where the waters are located. The plaintiffs in this lawsuit, Ohio Valley Environmental Coalition v. Whitman, challenge provisions in West Virginia's antidegradation implementation policy that exempt current holders of National Pollutant Discharge Elimination System (NPDES) permits and Section 404 permits, among other parties, from the antidegradation-review process. The Company is exempt from antidegradation review under these provisions. Revoking this exemption and subjecting the Company to the antidegradation review process could delay the issuance or reissuance of Clean Water Act permits to the Company or cause these permits to be denied. If the plaintiffs are successful and if the Company discharges into waters that have been designated as high-quality by the state, the costs, time and difficulty associated with obtaining and complying with Clean Water Act permits for surface mining of its operations could increase.

Comprehensive Environmental Response, Compensation and Liability Act. CERCLA and similar state laws affect coal mining operations by, among other things, imposing cleanup requirements for threatened or actual releases of hazardous substances that may endanger public health or welfare or the environment. Under CERCLA and similar state laws, joint and several liability may be imposed on waste generators, site owners and lessees and others regardless of fault or the

legality of the original disposal activity. Although the EPA excludes most wastes generated by coal mining and processing operations from the hazardous waste laws, such wastes can, in certain circumstances, constitute hazardous substances for the purposes of CERCLA. In addition, the disposal, release or spilling of some products used by coal companies in operations, such as chemicals, could implicate the liability provisions of the statute. Thus, coal mines that the Company currently owns or has previously owned or operated, and sites to which the Company sent waste materials, may be subject to liability under CERCLA and similar state laws. In particular, the Company may be liable under CERCLA or similar state laws for the cleanup of hazardous substance contamination at sites where it owns surface rights.

Mining Permits and Approvals. Numerous governmental permits or approvals are required for mining operations. In connection with obtaining these permits and approvals, the Company may be required to prepare and present to federal, state or local authorities data pertaining to the effect or impact that any proposed production of coal may have upon the environment. The requirements imposed by any of these authorities may be costly and time consuming and may delay commencement or continuation of mining operations. Regulations also provide that a mining permit can be refused or revoked if an officer, director or a shareholder with a 10% or greater interest in the entity is affiliated with another entity that has outstanding permit violations. Thus, past or ongoing violations of federal and state mining laws could provide a basis to revoke existing permits and to deny the issuance of additional permits.

In order to obtain mining permits and approvals from state regulatory authorities, mine operators, including the Company, must submit a reclamation plan for restoring, upon the completion of mining operations, the mined property to its prior condition, productive use or other permitted condition. Typically the Company submits the necessary permit applications several months before it plans to begin mining a new area. In the Company's experience, permits generally are approved several months after a completed application is submitted. In the past, the Company has generally obtained its mining permits without significant delay. However, the Company cannot be sure that it will not experience difficulty in obtaining mining permits in the future.

Future legislation and administrative regulations may emphasize the protection of the environment and, as a consequence, the activities of mine operators, including the Company, may be more closely regulated. Legislation and regulations, as well as future interpretations of existing laws, may also require substantial increases in equipment expenditures and operating costs, as well as delays, interruptions or the termination of operations. The Company cannot predict the possible effect of such regulatory changes.

Under some circumstances, substantial fines and penalties, including revocation or suspension of mining permits, may be imposed under the laws described above. Monetary sanctions and, in severe circumstances, criminal sanctions may be imposed for failure to comply with these laws.

West Virginia Cumulative Hydrologic Impact Analysis Litigation. Two environmental groups sued the West Virginia Department of Environmental Protection in January 2000 in federal court, alleging various violations of the Clean Water Act and SMCRA. The lawsuit was amended in September 2001 to name Gale Norton, Secretary of the Interior, as a defendant. The U.S. Office of Surface Mining is a division within the Department of Interior. The lawsuit, Ohio River Valley Environmental Coalition, Inc. v. Castle, specifically alleges that the West Virginia Department of Environmental Protection has violated its non-discretionary duty to require all surface and underground mining permit applications to include certain stream flow and water quality data and an analysis of the probable hydrologic consequences of the proposed mine, and that the West Virginia Department of Environmental Protection failed to conduct SMCRA-required cumulative hydrologic impacts analysis prior to issuing mining permits. The lawsuit also alleges that the Office of Surface Mining has a non-discretionary duty to apply the federal SMCRA law in West Virginia due to the deficiencies in the state program. In March 2001, the district court denied the plaintiff's motion for a preliminary injunction on its claims against the West Virginia Department of Environmental Protection. In September 2001, the district court denied a motion to dismiss for lack of jurisdiction under Bragg filed by defendant Michael Callaghan, Secretary of the West Virginia Department of Environmental Protection. Callaghan filed an interlocutory appeal of this decision in October 2001. The Fourth Circuit Court of Appeals is awaiting briefing under an extended schedule in this case. If the plaintiffs are eventually successful in this lawsuit, the West Virginia Department of Environmental Protection will have to modify its procedures and requirements for the content and review of mining permit applications, or the federal government will be ordered to assume control over mining permits in West Virginia. Any of

these changes are likely to increase the cost of preparing applications and the time required for their review, and may entail additional operating expenditures and, possibly, restrictions on operating.

West Virginia SMCRA Bond Lawsuit. In November 2000, the West Virginia Highlands Conservancy filed a lawsuit in federal district court against the U.S. Department of Interior, the U.S. Office of Surface Mining and the West Virginia Department of Environmental Protection. The lawsuit, West Virginia Highlands Conservancy v. Norton, which seeks declaratory and injunctive relief, generally challenges the adequacy of the two-tier West Virginia alternative bond reclamation program. The first tier requires mine operators to post a bond of up to \$5,000 per acre mined. The second tier creates a special reclamation fund which is funded by an assessment on mine operators of three cents per ton of coal. The West Virginia Highlands Conservancy claims that, individually and collectively, the alternative bond reclamation program has inadequate funds to cover the state's cost of conducting mining site reclamation for those sites where the mine operator has defaulted, or might default, on its reclamation obligations. Based upon the alleged inadequacy of the alternative bonding program, the lawsuit claims that the Department of the Interior and the Office of Surface Mining violated their obligations under SMCRA by either (1) not asserting federal control over the West Virginia SMCRA bonding program or (2) not revoking federal approval of the West Virginia SMCRA program and assuming control under SMCRA. The lawsuit also alleges that the West Virginia Department of Environmental Protection (1) failed to ensure that the state bonding program met certain minimum requirements and (2) improperly issued SMCRA permits without requiring mine operators to post sufficient reclamation bonds.

In May 2001, the district court dismissed all claims against the West Virginia Department of Environmental Protection based upon the principle of sovereign immunity. The Office of Surface Mining, in June 2001, initiated formal administrative action against the West Virginia Department of Environmental Protection regarding the alleged deficiencies in the state bonding program.

The remaining claims in this lawsuit against the federal defendants were the subject of an August 2001 order by the district court. The court denied the federal defendants' motion to dismiss the suit and granted partial summary judgment for the plaintiffs. The court allowed the Office of Surface Mining to continue its administrative action. That action required the West Virginia Department of Environmental Protection to submit proposed new regulatory initiatives to the state legislature's rulemaking committee and, within 45 days of the close of the 2002 legislative session, the state was required to provide final, enacted legislation, signed by the Governor of West Virginia, that addressed all problems with the current state bonding system. The West Virginia Legislature passed, and the Governor of West Virginia signed, an amended alternative bond program, called the 7-Up Plan, and the U.S. Office of Surface Mining approved those amendments.

The plaintiffs filed a motion in January 2002 asking the court to compel the Office of Surface Mining to perform its non-discretionary duties and find that the new alternative bonding program promulgated by West Virginia still fails to meet the requirements of the federal SMCRA. In March 2002, the court denied the plaintiffs' motion, based in part upon representations by the Office of Surface Mining that it would make a final determination regarding the adequacy of the 7-Up Plan by no later than May 28, 2002.

On May 29, 2002, the Office of Surface Mining issued a final rule that approved amendments to the West Virginia alternative bonding scheme adopted by the West Virginia Department of Environmental Protection and enacted by the state legislature. These amendments require, among other things, eliminating the current deficit and restoring the Special Reclamation Fund to solvency, removing spending limitations on the expenditure of funds for water treatment, creating a special advisory council to advise on structural reforms to the bonding program to avoid deficits in the future and annual reporting to the state legislature on the adequacy of the funds in the alternative bonding scheme.

The current deficit will be eliminated through special reclamation taxes on clean coal totaling fourteen cents per ton, of which seven cents is an additional temporary tax that will terminate in 39 months. The Office of Surface Mining has projected that these taxes will eliminate the deficit. These taxes and whatever other requirements may be adopted in the future by the advisory council will likely result in increases in the funds that mine operators are required to post in order to obtain permits and could result in further additional costs or fees related to the operation of a coal mine or the sale of coal. Any changes to the state reclamation bonding program could also complicate and protract the process of applying for and obtaining necessary permits.

On June 25, 2002, the West Virginia Highlands Conservancy filed an amended complaint challenging the Office of Surface Mining's approval of the amendments to the West Virginia alternative bonding program.

**Endangered Species.** The federal Endangered Species Act and counterpart state legislation protects species threatened with possible extinction. Protection of endangered species may have the effect of prohibiting or delaying the Company from obtaining mining permits and may include restrictions on timber harvesting, road building and other mining or silvicultural activities in areas containing the affected species. A number of species indigenous to the Company's properties are protected under the Endangered Species Act. Based on the species that have been identified to date and the current application of applicable laws and regulations, however, the Company does not believe there are any species protected under the Endangered Species Act that would materially and adversely affect its ability to mine coal from its properties in accordance with current mining plans.

**Other Environmental Laws Affecting the Company.** The Company is required to comply with numerous other federal, state and local environmental laws in addition to those previously discussed. These additional laws include, for example, the Resource Conservation and Recovery Act, the Safe Drinking Water Act, the Toxic Substance Control Act and the Emergency Planning and Community Right-to-Know Act. The Company believes that it is in substantial compliance with all applicable environmental laws.

#### Competition-Excess Industry Capacity.

The coal industry is intensely competitive, primarily as a result of the existence of numerous producers in the coal-producing regions in which the Company operates, and a number of the Company's competitors have greater financial resources. The Company competes with several major coal producers in the central Appalachian and Powder River Basin areas. The Company also competes with a number of smaller producers in those and other market regions. The Company is also subject to the risk of reduced profitability as a result of excess industry capacity, which results in reduced coal prices.

#### Electric Industry Factors.

Demand for coal and the prices that the Company will be able to obtain for its coal are closely linked to coal consumption patterns of the domestic electric generation industry, which has accounted for approximately 90% of domestic coal consumption in recent years. These coal consumption patterns are influenced by factors beyond the Company's control, including the demand for electricity (which is dependent to a significant extent on summer and winter temperatures); government regulation; technological developments and the location, availability, quality and price of competing sources of coal; alternative fuels such as natural gas, oil and nuclear; and alternative energy sources such as hydroelectric power. Demand for the Company's low-sulfur coal and the prices that the Company will be able to obtain for it will also be affected by the price and availability of high-sulfur coal, which can be marketed in tandem with emissions allowances in order to meet federal Clean Air Act requirements. Any reduction in the demand for the Company's coal by the domestic electric generation industry may cause a decline in profitability.

Electric utility deregulation is expected to provide incentives to generators of electricity to minimize their fuel costs and is believed to have caused electric generators to be more aggressive in negotiating prices with coal suppliers. Deregulation may have a negative effect on the Company's profitability to the extent it causes the Company's customers to be more cost-sensitive.

#### Reliance On And Terms Of Long-Term Coal Supply Contracts.

During 2001, sales of coal under long-term contracts, which are contracts with a term greater than 12 months, accounted for 77% of the Company's total revenues. The prices for coal shipped under these contracts may be below the current market price for similar type coal at any given time. As a consequence of the substantial volume of its sales which are subject to these long-term agreements, the Company has less coal available with which to capitalize on stronger coal prices if and when they arise. In addition, because long-term contracts typically allow the customer to elect volume flexibility, the Company's ability to realize the higher prices that may be available in the spot market may be restricted when customers elect to purchase higher volumes under such contracts, or the Company's exposure to market-based pricing may be increased should

customers elect to purchase fewer tons. The increasingly short terms of sales contracts and the consequent absence of price adjustment provisions in such contracts also make it more likely that inflation related increases in mining costs during the contract term will not be recovered by the Company.

#### Reserve Degradation And Depletion.

The Company's profitability depends substantially on its ability to mine coal reserves that have the geological characteristics that enable them to be mined at competitive costs. Replacement reserves may not be available when required or, if available, may not be capable of being mined at costs comparable to those characteristic of the depleting mines. The Company has in the past acquired and will in the future acquire, coal reserves for its mine portfolio from third parties. The Company may not be able to accurately assess the geological characteristics of any reserves that it acquires, which may adversely affect the profitability and financial condition of the Company. Exhaustion of reserves at particular mines can also have an adverse effect on operating results that is disproportionate to the percentage of overall production represented by such mines. Mingo Logan's Mountaineer Mine is estimated to exhaust its longwall mineable reserves in 2006. The Mountaineer Mine generated \$21.1 million and \$20.0 million of the Company's total operating income in the first half of 2002 and 2001, respectively.

#### Potential Fluctuations In Operating Results-Factors Routinely Affecting Results Of Operations.

The Company's mining operations are inherently subject to changing conditions that can affect levels of production and production costs at particular mines for varying lengths of time and can result in decreases in profitability. Weather conditions, equipment replacement or repair, fuel prices, fires, variations in coal seam thickness, amounts of overburden rock and other natural materials and other geological conditions have had, and can be expected in the future to have, a significant impact on operating results. A prolonged disruption of production at any of the Company's principal mines, particularly its Mingo Logan operation in West Virginia or Black Thunder mine in Wyoming, would result in a decrease, which could be material, in the Company's revenues and profitability. Other factors affecting the production and sale of the Company's coal that could result in decreases in its profitability include: (i) expiration or termination of, or sales price redeterminations or suspension of deliveries under, coal supply agreements; (ii) disruption or increases in the cost of transportation services; (iii) changes in laws or regulations, including permitting requirements; (iv) litigation; (v) the timing and amount of insurance recoveries; (vi) work stoppages or other labor difficulties; (vii) mine worker vacation schedules and related maintenance activities; and (viii) changes in coal market and general economic conditions.

#### Transportation.

The coal industry depends on rail, trucking and barge transportation to deliver shipments of coal to customers, and transportation costs are a significant component of the total cost of supplying coal. Disruption of these transportation services could temporarily impair the Company's ability to supply coal to its customers. Increases in transportation costs, or changes in such costs relative to transportation costs for coal produced by its competitors or of other fuels, could have an adverse effect on the Company's business and results of operations.

#### Reserves - Title.

There are numerous uncertainties inherent in estimating quantities of recoverable reserves, including many factors beyond the control of the Company. Estimates of economically recoverable coal reserves and net cash flows necessarily depend upon the number of variable factors and assumptions, such as geological and mining conditions which may not be fully identified by available exploration data or may differ from experience in current operations, historical production from the area compared with production from other producing areas, the assumed effects of regulation by governmental agencies and assumptions concerning coal prices, operating costs, severance and excise taxes, development costs and reclamation costs, all of which may cause estimates to vary considerably from actual results.

For these reasons, estimates of the economically recoverable quantities attributable to any particular group of properties, classifications of such reserves based on risk of recovery and estimates of net cash flows expected

therefrom, prepared by different engineers or by the same engineers at different times, may vary substantially. Actual coal tonnage recovered from identified reserve areas or properties and revenues and expenditures with respect to the Company's reserves may vary from estimates, and such variances may be material. These estimates thus may not accurately reflect the Company's actual reserves.

A significant part of the Company's mining operations are conducted on properties leased by the Company. The loss of any lease could adversely affect the Company's ability to develop the associated reserves. Because title to most of the Company's leased properties and mineral rights is not usually verified until a commitment is made by the Company to develop a property, which may not occur until after the Company has obtained necessary permits and completed exploration of the property, the Company's right to mine certain of its reserves may be adversely affected if defects in title or boundaries exist. In order to obtain leases or mining contracts to conduct mining operations on property where these defects exist, the Company has had to, and may in the future have to, incur unanticipated costs. In addition, the Company may not be able to successfully negotiate new leases or mining contracts for properties containing additional reserves or maintain its leasehold interests in properties on which mining operations are not commenced during the term of the lease.

#### Certain Contractual Arrangements.

The Company's affiliate, Arch Western Resources, LLC, is the owner of Company reserves and mining facilities in the western United States. The agreement under which Arch Western was formed provides that a subsidiary of the Company, as the managing member of Arch Western, generally has exclusive power and authority to conduct, manage and control the business of Arch Western. However, consent of BP Amoco, the other member of Arch Western, would generally be required in the event that Arch Western proposes to make a distribution, incur indebtedness, sell properties or merge or consolidate with any other entity if, at such time Arch Western has a debt rating less favorable than specified ratings with Moody's Investors Service or Standard & Poor's or fails to meet specified indebtedness and interest ratios.

In connection with the Company's June 1, 1998 acquisition of Atlantic Richfield Company's ("ARCO") coal operations, the Company entered into an agreement under which it agreed to indemnify ARCO against specified tax liabilities in the event that these liabilities arise as a result of certain actions taken prior to June 1, 2013, including the sale or other disposition of certain properties of Arch Western, the repurchase of certain equity interests in Arch Western by Arch Western or the reduction under certain circumstances of indebtedness incurred by Arch Western in connection with the acquisition. Depending on the time at which any such indemnification obligation were to arise, it could impact the Company's profitability for the period in which it arises.

The membership interests in Canyon Fuel, which operates three coal mines in Utah, are owned 65% by Arch Western and 35% by a subsidiary of ITOCHU Corporation of Japan. The agreement which governs the management and operations of Canyon Fuel provides for a management board to manage its business and affairs. Some major business decisions concerning Canyon Fuel require the vote of 70% of the membership interests and therefore limit the Company's ability to make these decisions. These decisions include admission of additional members; approval of annual business plans; the making of significant capital expenditures; sales of coal below specified prices; agreements between Canyon Fuel and any member; the institution or settlement of litigation; a material change in the nature of Canyon Fuel's business or a material acquisition; the sale or other disposition, including by merger, of assets other than in the ordinary course of business; incurrence of indebtedness; entering into leases; and the selection and removal of officers. The Canyon Fuel agreement also contains various restrictions on the transfer of membership interests in Canyon Fuel.

The Company's Amended and Restated Certificate of Incorporation requires the affirmative vote of the holders of at least two-thirds of outstanding common stock voting thereon to approve a merger or consolidation and certain other fundamental actions involving or affecting control of the Company. The Company's Bylaws require the affirmative vote of at least two-thirds of the members of the Board of Directors of the Company in order to declare dividends and to authorize certain other actions.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The information required by this Item is contained under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations" in this report and is incorporated herein by reference.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The information required by this Item is contained in the "Contingencies - Legal Contingencies" section of "Management's Discussion and Analysis of Financial Condition and Results of Operations" in this report and is incorporated herein by reference.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITIES HOLDERS

(a) The Company's Annual Meeting of Stockholders was held on April 25, 2002, at the Company's headquarters at One CityPlace Drive, St. Louis, Missouri, at 10:00 a.m., central time.

(b) At such Annual Meeting, the holders of the Company's common stock elected the following nominees for director:

Nominee	Total Votes For	Total Votes Withheld
James R. Boyd	41,998,937	1,595,502
Douglas H. Hunt	42,027,937	1,566,502
A. Michael Perry	42,007,048	1,587,391

At such Annual Meeting, the Company's stockholders, by a vote of 21,886,589 for, 15,157,678 against and 99,253 abstained, also approved an amendment to increase the number of shares under the Arch Coal, Inc. 1997 Stock Incentive Plan.

At such Annual Meeting, the Company's stockholders, by a vote of 38,587,248 for, 4,903,997 against and 103,191 abstained, also approved the Arch Coal, Inc. 1997 Stock Incentive Plan for purposes of Section 162(m) of the Internal Revenue Code of 1986, as amended.

At such Annual Meeting, the Company's stockholders, by a vote of 42,527,493 for, 1,029,013 against and 37,931 abstained, also ratified the appointment of Ernst & Young LLP as the Company's independent auditors for 2002.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a)

3.1 Amended and Restated Certificate of Incorporation of Arch Coal, Inc. (incorporated herein by reference to Exhibit 3.1 to the Company's Quarterly Report on Form 10-Q for the Quarter Ended March 31, 2000)

3.2 Amended and Restated Bylaws of Arch Coal, Inc. (incorporated herein by reference to Exhibit 3.2 to the Company's Annual Report on Form 10-K for the Year Ended December 31, 2000)

4.1 Form of Rights Agreement, dated March 3, 2000, between Arch Coal, Inc. and First Chicago Trust Company of New York, as Rights Agent (incorporated herein by reference to Exhibit 1 to a Current Report on Form 8-A filed on March 9, 2000)

99.1 Statement Under Oath of Principal Executive Officer Regarding Facts and Circumstances Relating to Exchange Act Filings executed by Steven F. Leer

99.2 Statement Under Oath of Principal Financial Officer Regarding Facts and Circumstances Relating to Exchange Act Filings executed by Robert J. Messey.

(b) Reports on Form 8-K

Reports on Form 8-K: A report on Form 8-K dated April 22, 2002 announcing the Company's first quarter earnings was filed by the Company in the quarter ended June 30, 2002.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

ARCH COAL, INC.

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(Registrant)

Date: August 8, 2002

/s/ John W. Lorson

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John W. Lorson  
Controller  
(Chief Accounting Officer)

CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Arch Coal, Inc. (the "Company") on Form 10-Q for the period ending June 30, 2002 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), the undersigned, Steven F. Leer, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. ss. 1350, as adopted pursuant to ss. 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Steven F. Leer

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Steven F. Leer  
Chief Executive Officer  
August 7, 2002

CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Arch Coal, Inc. (the "Company") on Form 10-Q for the period ending June 30, 2002 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), the undersigned, Robert J. Messey, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. ss. 1350, as adopted pursuant to ss. 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Robert J. Messeyu

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Robert J. Messey  
Chief Financial Officer  
August 7, 2002